

Covered Bonds: Background and Policy Issues

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Summary

Covered bonds are a relatively common method of funding mortgages in Europe, but uncommon in the United States. A covered bond is a recourse debt obligation that is secured by a pool of assets, often mortgages. The holders of the bond are given additional protection in the event of bankruptcy or insolvency of the issuing lender. Covered bonds have some features, such as pooled mortgages, that resemble securitization, but the original lenders maintain a continuing interest in the performance of the loans. Because some believe that the subprime mortgage turmoil may have been influenced by poor incentives for lenders using the securitization process, some policymakers have recommended covered bonds as an alternative for U.S. mortgage markets. Although covered bond contracts are not prohibited in the United States, some policymakers believe that legislation and agency rulemaking could facilitate the growth of a domestic covered bond market.

In some countries, covered bonds conforming to statutorily prescribed features may receive enhanced protections or greater regulatory certainty. A statutory framework for covered bonds often includes four elements: (1) the bond is issued by (or bondholders otherwise have full recourse to) a credit institution that is subject to public supervision and regulation; (2) bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution; (3) the credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times; and (4) in addition to general supervision of the issuing institution, public or other independent bodies supervise the institution's specific obligations to the covered bonds. Some analysts include the presence of such a statutory framework in the definition of a covered bond, in which case there have not been any covered bonds issued in the United States (and many so-called covered bonds issued elsewhere would also no longer be rightfully called covered bonds).

Compared with securitization, covered bonds may be less susceptible to poor underwriting standards because issuers maintain risk exposure or "skin in the game," perhaps minimizing problems of the "originate to distribute" model of lending. Institutions that issue covered bonds may be less susceptible to investor panic because the status of covered bonds on their balance sheet is transparent. On the other hand, reliance on covered bonds may reduce aggregate lending because it ties up more capital than does securitization.

Potentially, there could be some regulatory uncertainty on the treatment of holders of covered bonds when the Federal Deposit Insurance Corporation (FDIC) places banks in receivership or conservatorship. To address some of these concerns, the FDIC issued two policy statements in 2008 clarifying its obligations to the holders of covered bonds if an FDIC-insured institution is placed in FDIC receivership or conservatorship. Because the use of covered bonds in the United States is rare, there is still little experience in actually resolving a covered bond.

This report will be updated as conditions warrant.

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Covered bonds are one method for financial institutions to raise funds from investors. They are rare in the United States, although variations of covered bonds have been used in Europe for centuries. Although covered bonds are not a prohibited form of debt contract in the United States, some observers believe that legislation and agency rulemaking is required to facilitate the growth of a larger domestic covered bond market.

Congressional Interest

Congress has conducted hearings on alternatives to government-sponsored enterprises (GSEs). Policymakers are considering increased reliance on covered bonds as an alternative to securitization. This report discusses various definitions of covered bonds, analyzes some of the economic advantages and disadvantages of this funding mechanism compared with securitization, and summarizes recent legislative proposals.

Definitions

Conceptually, a covered bond is a way for financial institutions to raise funds by offering collateral to investors. A bank sells a bond to investors, and the bond is backed both by the bank's promise to repay and by the assets pledged as collateral.¹ It is important to distinguish between the debt that serves as the collateral and the debt that is the bond itself. A covered bond is a debt in which a financial institution is the borrower. The primary collateral backing the covered bond is also debt, often mortgages in which the financial institution was the lender or has a close relationship with the lender. A covered bond typically uses mortgages (or other debt) as collateral for a bond that a financial institution sells to investors.

It is difficult to present a single technical definition of existing covered bonds because variations of this debt contract have been used in many European countries for centuries. In some countries, variations of covered bonds can be constructed through private contract. In other countries, covered bonds conforming to statutorily prescribed features may receive enhanced protections. For such statutorily protected covered bonds, according to the European Central Bank (ECB), the closest thing to a shared definition is European Covered Bond Council's "essential features of covered bonds," which includes four elements: (1) the bond is issued by (or bondholders otherwise have full recourse to) a credit institution which is subject to public supervision and regulation; (2) bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution; (3) the credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times; and (4) the obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.² If that definition is accepted, then no U.S. covered bonds are actually covered bonds because the United States does not as yet have an independent cover pool supervisor.

A comparison to other sources of funds for financial institutions may be helpful in understanding covered bonds. A distinguishing feature of a covered bond is that it is dual-recourse, which means that the investor has recourse against both the financial institution selling the bond and the pool of

¹ International Monetary Fund (IMF), *Global Financial Stability Report*, "Chapter 2: Restarting Securitization Markets," October 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf>.

² "Covered Bonds in the EU Financial System," European Central Bank, December 2008, p. 6, available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf.

assets backing the bond.³ In contrast, a bank or other financial institution could offer a bond with no collateral, in which case the bond is a form of unsecured debt. Alternatively, the financial institution could sell the underlying loans to an independent collateral pool that serves as the only backing of the bond, in which case the bond is a typical American private-label asset-backed security (ABS). If backed by mortgages, the ABS is a mortgage-backed security (MBS). **Table 1** compares the typical covered bond structures to unsecured debt and ABS or MBS. Variations on the general structures are presented in the table, for example, Fannie Mae and Freddie Mac (the government-sponsored enterprises, GSEs) typically guarantee credit risk for their MBS. Note that **Table 1** is a general description; it is possible to design ABS and covered bonds in which there is a claim against the issuing financial institution for some kinds of risks but not for others.

Table 1. Investor Recourse for Selected Financial Institution Funding Sources

		Claim Against Collateral Pool	
		No	Yes
Claim Against Financial Institution	No		Private-Label ABS and MBS
	Yes	Unsecured Debt	Covered Bond GSE MBS

Source: Covered Bonds in the EU Financial System, available at http://www.ecb.int/pub/pdf/other/coverbondsintheetufinancialsystem200812en_en.pdf.

American banks are not prohibited from using the covered bond contract to raise funds, although there are few American covered bonds. In practice, the Federal Deposit Insurance Corporation (FDIC) may have the ability to limit the market for covered bonds through its regulatory power over insured depositories. For example, the FDIC can limit the type of collateral that may be used or the percent of the depository's balance sheet that is funded with covered bonds. The FDIC defined covered bonds in FIL 73-2008 on August 4, 2008. The policy statement defines a covered bond as:

a non-deposit, recourse debt obligation of an IDI [Insured Depository Institution] with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series.⁴

Because securitization is more common than covered bonds in the United States, it may be helpful to compare typical features of private securitization to typical features of covered bonds. As discussed above, covered bonds are supported by both the pledged mortgages (or other assets) and the issuing bank, but there are other elements of interest to some policymakers (discussed in more detail below). For example, covered bonds typically remain on the balance sheet of sponsoring institutions while securitized assets typically do not. Therefore, covered bonds typically tie up more capital than typical securitizations. On the other hand, issuers of covered bonds typically have more long-term stake in the performance of the assets in the cover pool than

³ "Covered Bond Primer for the Uninitiated," Sabine Winkler and Alexander Batchvarov, Bank of America Merrill Lynch, January 22, 2010, at <http://ihfp.wharton.upenn.edu/Main%20Course%20Readings%5CModule%20V%20-%20Types%20of%20Funding%20Models%5CMortgage%20Bond%20Funding/B-BOA,%20ML%20-%20Covered%20Bond%20Primer.pdf>.

⁴ "FDIC Policy Statement on Covered Bonds," FIL 73-2008, FDIC, August 4, 2008, available at <http://www.fdic.gov/news/news/financial/2008/fil08073.html>.

typical securitization. **Table 2** compares selected features of covered bonds to typical private securitization of U.S. mortgages.

Table 2. Comparing the Structure of Securitization and Covered Bonds

	Private Securitization	Covered Bonds
Structure	Issuer gathers mortgages (or other assets) from one or more banks in a pool and sells securities which represent claims on the cash flow of the pool.	A bank puts its own mortgages (or other assets) in a pool, sells interest in the pool, and stands ready to cover losses if the pool does not perform.
Claims of bondholders against mortgage pool	Bondholders have claim against mortgages in pool.	Bondholders have claim against mortgages in pool.
Claims of bondholders against loan originator	Bondholders do not have claim against other assets of loan originators (assuming the issuer does not provide credit enhancement).	If mortgage pool exhausted, bondholders retain claim against loan originator.
Balance sheet treatment	Usually NOT recorded as a liability of the loan originator or securities issuer.	Usually recorded as a liability of the loan originator or covered bond issuer.
Loan originator record of sale on assets	Gain on sale when sold to trust, subject to accounting standards.	The mortgages are not sold so no gain to record.
Servicing the loan	Originators sold the loans so servicing is an independent relationship, but originator can service loan under contract.	No isolation of originator from mortgage assets, so servicing relationship unaffected.
Originator bankruptcy	Mortgages in the pool are remote from bankruptcy of the loan originator.	Bondholders have full claims on mortgages in pool even if loan originator is in insolvency proceedings.
Ratings agencies	Assess only the risk of the assets and credit enhancement in the mortgage pool.	Must assess risk of assets in pool but also the risk of the issuing bank as a whole.

Source: Vinod Kothari, *Securitization: Financial Instrument of the Future* (New Jersey: John Wiley & Sons, 2006), p. 357.

Policy Issues

The steep drop in the volume of securitization and the GSE intervention of 2008 have encouraged some policymakers to consider alternative funding sources for mortgage finance. Covered bonds might be less subject to investor loss of confidence than securitization because covered bond issuers maintain a long-term interest in the underlying loans and because the exposure of banks to covered bonds remains recorded on their balance sheets.⁵ These potential advantages would have to be weighed against less advantageous capital requirements for issuing institutions and potential costs to the FDIC's deposit insurance fund. Some potential economic benefits and costs of covered bonds are presented below.

⁵ IMF, *Global Financial Stability Report*, "Chapter 2: Restarting Securitization Markets," October 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf>.

“Skin in the Game” and Underwriting

The foreclosure crisis has caused some to question the long-term incentives of securitization. In securitization, lenders sell their loans to the secondary market. Because institutions in the primary mortgage market do not retain risk of borrower default, that is, do not have “skin in the game,” there may not be a sufficient check against eroding underwriting standards.⁶

An alternative approach would be to mandate that issuers in securitization retain some pre-specified amount of risk. A potential downside of this approach is that it might encourage the creation of more complex financial instruments. Mandating that banks retain only a part of risk requires the creation of instruments that can divide the risk between the issuers and the holders of the securities. Regulators are charged with making sure that the portion of risk being retained by the issuer is not being hedged, because hedging would defeat the purpose of the retained risk regulation. Securities issuers still want to avoid risk, so they would have an incentive to create complex instruments that complicate regulators’ efforts to monitor their retained risk and hedging activities.

Advocates of covered bonds point out that the issuers maintain a long term stake in the performance of the loans.⁷ If the underlying loans default, the financial institution is still responsible for payments to the holders of the covered bonds. By its nature, a covered bond requires issuers to have 100% skin in the game, which presumably encourages the maintenance of quality underwriting standards.

The distinction between statutory and contractual covered bonds allows for further refinement. Recall that a covered bond contract is not currently prohibited, which in theory means that firms can offer a variety of covered bond structures. In practice, financial regulatory agencies could limit the collateral eligible for covered bonds issued by regulated institutions. Similarly, Congress could enact a statutory framework that limits the collateral eligible for covered bonds by any or all lenders. A statutory framework for covered bonds, or for securitization, could limit eligible collateral to loans with quality underwriting. The FDIC has issued related guidance.

Transparency and Investor Confidence

The complexity of asset securitization may have contributed to financial market turmoil and panic. For investors evaluating firms that had issued securitized assets, it was not always clear if issuers would have to support the securities they had sold that were off the current balance sheet (a contingent liability). For investors evaluating the securities themselves, the complexities of MBS construction may have made it difficult to estimate the current value of the securities or anticipate write-downs by institutions holding them. The loss of investor confidence may have been exacerbated by lack of transparency of securitized mortgages.

Advocates of covered bonds argue that they have a financial structure that is more transparent than securitization.⁸ Balance sheets of covered bond issuers may more accurately reflect risks because the issuers of covered bonds do not sell the assets. Investors evaluating the health of covered bond issuers are less likely to be surprised by a contingent liability of the issuer because

⁶ “Testimony of Patricia McCoy Before the Senate Committee on Banking, Housing, and Urban Affairs,” October 7, 2009, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=02242b1f-27e9-4aa0-ae0f-3a1c0eacc7e6.

⁷ “Written testimony of Wesley Phoa,” House Committee on Financial Services, December 15, 2009, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/phoa.pdf.

⁸ IMF, *Global Financial Stability Report*, “Chapter 2: Restarting Securitization Markets,” October 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf>.

the issuer has already disclosed a promise to support the bonds. Similarly, the typical covered bond transaction is less likely than securitization to issue multiple classes of complex securities from the same underlying loan pool because the issuer is promising to pay investors anyway. Here again, regulatory agencies and Congress have the option to further encourage transparency by creating a statutory framework, although in theory similar revisions could be done to support transparency in securitization.

Capital Requirements and Lending Volume

Regulatory agencies encouraged securitization in the 1990s, in part because this was believed to transfer default risk out of the banking system.⁹ Bank regulations allowed securitizers to reduce capital because the loans were typically sold off the balance sheet of the issuer.¹⁰ Therefore, securitization may have enabled a higher volume of lending for a given amount of capital in the banking system. Policymakers considering a future shift from securitization to covered bonds would have to take into account the advantages and disadvantages of higher potential capital requirements and lower lending volume.

Like securitization, covered bonds essentially allow lenders to access investors in the secondary market without necessarily obtaining capital from them. In other words, the sale of a covered bond does not itself add capital to the balance sheet of a covered bond issuer, just as the sale of a MBS does not itself add capital to an MBS issuer. Unlike securitization, investors in covered bonds have recourse against the covered bond issuer. Therefore, issuers of covered bonds would have more risk than sellers of MBS, and would have to hold more risk-based capital to support the funding of the same volume of lending, all else equal. As a result, a shift to covered bonds could require either more resources to be held as capital in the banking system, or less overall lending, or some combination of the two.

Policymakers could change the relative capital treatment of securitized assets and covered bonds. Financial regulatory agencies have altered the accounting treatment of certain securitized assets, which could reduce the relative advantage of securitization. For example, FDIC guidance on Financial Accounting Standards (FAS) 166 and 167 could result in securitizers retaining more capital than under prior accounting rules.¹¹ To the extent recent regulatory actions may increase capital requirements under securitization, the relative capital disadvantage of covered bonds may decline in the near future.

Maturity Mismatch

In banking, maturity generally refers to the length of time that a borrower has to repay the loan.¹² In general, much of a bank's liabilities are short-term instruments. For example, customer deposits are subject to immediate withdrawal on demand. However, many of a bank's assets have

⁹ "Asset Securitization," Comptrollers Handbook, OCC, 1997, available at <http://www.occ.treas.gov/handbook/assetsec.pdf>.

¹⁰ Regulated banks are subject to a number of regulatory and risk-based capital requirements. Mortgage loans and other risky lending assets that are held on bank balance sheets require capital in relation to their risk. Typically, a bank that sells or securitizes a loan no longer has to hold its associated risk-based capital for that asset.

¹¹ "Regulatory Capital Standards: Final Rule Amending the Risk-Based Capital Rules to Reflect the Issuance of FAS 166 and FAS 167," Financial Institution Letter FIL 3-2010, FDIC, January 21, 2010, available at <http://www.fdic.gov/news/news/financial/2010/fil10003.html>.

¹² The term duration is often used to refer to a more precise measure of risks associated with timing on a financial institution's balance sheet.

a longer maturity, such as 30-year fixed-rate mortgages. This general bank structure has a maturity mismatch, which exposes the banking system to potential problems when interest rates unexpectedly suffer extreme fluctuations. One perceived advantage of securitization was that it allowed banks to sell their long-term assets, and thus potentially better cope with the maturity of mortgages and similar assets.¹³ Under securitization, a bank (which has short maturity liabilities) could sell a mortgage (a long maturity asset) to an insurance company (with long maturity liabilities) or other investors with tolerance for long-maturity assets.

Covered bonds are an intermediate case between funding loans held in portfolio through deposits and funding loans through securitization. Unlike securitization, covered bonds do not remove long-maturity assets from the issuer's balance sheet. Instead, a covered bond allows a bank to fund itself with a long-maturity liability. By matching long-term assets with long-term liabilities, covered bonds potentially allow banks to reduce maturity mismatch compared with portfolio lending funded solely through deposits and other short-term liabilities. However, a bank that issues a covered bond backed by a pool of mortgages must still cope with some maturity mismatch because the actual maturity of some loans, such as mortgages, is of uncertain length. For example, people might prepay their mortgage when they move. Therefore, an increased reliance on covered bonds rather than securitization might increase maturity-mismatch risks in the banking system to the degree that financial institutions cannot forecast the actual maturity of their loans. This might cause some institutions to increase their use of financial derivatives, which raise issues of transparency and risk themselves, if covered bonds were to replace securitization.

Failing Depositories and the Deposit Insurance Fund

The FDIC resolves failing banks with insured deposits. Once an institution has been seized by the FDIC, the greater the proceeds from the sale of its assets the smaller the potential loss to the FDIC's Deposit Insurance Fund (DIF). Generally, the FDIC has a superior claim to assets of failing banks. However, the point of covered bonds is generally to promote bondholder interests should the issuer fail to make the covered bond payments. Were the FDIC to minimize investor rights to collateral for failing banks, the market would probably find it difficult to sell covered bonds in the future. Because covered bonds are rare in the United States, some investors might want greater clarity regarding FDIC policies should a covered bond issuer fail. How will the FDIC treat investors in covered bonds should an issuer fail, and how might an increase in covered bonds affect the DIF?

Policymakers can protect the FDIC's DIF in any of a number of ways. For example, the amount of covered bonds that each institution could issue could be limited to a small portion of its overall balance sheet. Alternatively, investors in covered bonds could be put on notice that the FDIC has additional directives to protect the DIF should the fund run low. The FDIC could be directed to only recognize investor security interests in covered bonds after it is clear that there will be no drain on the DIF. If any of these options are chosen, economic theory predicts that the price investors would be willing to pay for a covered bond would reflect the decreased risk adjusted recovery of the bond. That is, banks might get lower revenues from issuing covered bonds when healthy, and investors would get lower recovery rates on covered bonds should a bank fail.

Alternatively, policymakers could choose to promote covered bonds relative to the DIF. For example, legislation could direct the FDIC to respect covered bond claims even at the expense of the DIF. Should this or a similar option be chosen, economic theory predicts that banks would generally get higher revenues from issuing covered bonds in good times, and investors would get

¹³ "Optimal Securitization with Moral Hazard," Barney Hartman-Glasery, Tomasz Piskorski, and Alexei Tchistyix, January 19, 2010, working paper available at http://faculty.haas.berkeley.edu/bhglaser/optimal_securitization.pdf.

higher recovery rates on covered bonds should a bank fail. If policymakers choose to promote covered bonds relative to the DIF then a potential future wave of bank failures might cause greater losses for taxpayers were the DIF to run out and the FDIC tap its line of credit with the Treasury.

Comparison to Federal Home Loan Bank Advances

Covered bonds have some characteristics in common with the Federal Home Loan Bank (FHLB) system. Like covered bonds, FHLB loans to their member institutions are dual recourse. Members of a regional FHLB pledge mortgages as collateral for FHLB loans, called advances. When member institutions fail, the regional FHLB gets paid before many other creditors of the bank. This repayment priority at the time of failure is called a superlien. The superlien is not only the pledged mortgages, rather the superlien can draw on the entire balance sheet of the financial institution. The net effect of requiring members to pledge the mortgages as collateral for the advances is to create a practical constraint on the volume of advances that any member institution can obtain (in addition to any other regulatory constraints). In practice, because money is easily transferrable, FHLB advances can be used to fund non-mortgage activities as long as the total volume of advances does not exceed the institution's holdings of mortgages.¹⁴

Some of these FHLB advance features resemble covered bonds. For example, both covered bonds and FHLB advances allow creditors to the financial institution to improve their priority in repayment should the firm fail. Both allow the mortgage originator to keep the funded mortgage on its own balance sheet, which can improve transparency. FHLBs monitor their members, which has some similarities to a public or independent monitor of the cover pool.

There are important differences between covered bonds and FHLB advances. A holder of a covered bond does not have recourse against the entire balance sheet of the financial institution; rather the holder of the covered bond has recourse to specific assets. Note that the issuer of the covered bond has some duties to maintain the value of the cover pool. The capital requirements for covered bonds need not be the same as capital requirements for FHLB advances. In many cases, FHLB advances are callable.

Agency Actions on Covered Bonds

In response to mortgage market turmoil in 2007 and 2008, the Treasury Department and the FDIC considered rulemaking to encourage the use of covered bonds as an alternative to mortgage securitization. They believed that covered bonds might be a more stable source of funding than securitization because the volume of American private-label mortgage securitizations collapsed as mortgage market turmoil progressed.¹⁵

Treasury Proposals and Best Practices

Proposals for facilitating covered bonds were not merely a reaction to the financial panic of September 2008. Covered bonds were being discussed prior to the Lehman Brothers bankruptcy.

¹⁴ "The Federal Home Loan Bank System: The Lender of Next to Last Resort," Adam Ashcraft, Morten Bech, and Scott Frame, Federal Reserve Bank of New York Staff Reports, No. 357, November 2008, available at http://www.ny.frb.org/research/staff_reports/sr357.pdf.

¹⁵ Private-label securitizations refer to mortgage-backed securities that are issued by firms other than the government-sponsored enterprises, Fannie Mae and Freddie Mac. Monthly private label mortgage securitizations approached zero, according to statistics from the Securities Industry and Financial Markets Association (SIFMA), available at http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedIssuance.pdf.

Following mortgage market turmoil in the summer of 2007, Treasury officials were concerned that investor confidence in the securitization of mortgages might not be sustainable under mortgage market conditions prevailing at that time. On March 13, 2008, Treasury officials suggested the increased use of covered bonds as one option to restore confidence in mortgage finance:

Covered bonds, which allow banks to retain originated mortgage loans while accessing financial market funding, are another alternative worth considering. Covered bonds may address the current lack of liquidity in, and bring more competition to, mortgage securitization. Rule-making, not legislation, is needed to facilitate the issuance of covered bonds. Through clarification of covered bonds' status in the event of a bank-issuer's insolvency, the FDIC can reduce uncertainty and consider appropriate measures that will protect the deposit insurance fund. These steps would encourage a covered bond market in the U.S.; similar changes in Europe have resulted in more covered bond activity.¹⁶

In an effort to provide clarity to the U.S. covered bond market, the Treasury Department issued a *Best Practices for Residential Covered Bonds* document on July 28, 2008.¹⁷ This guide was designed to function as a complement to the FDIC's April 30 and August 4, 2008, policy statements on covered bonds (discussed below), and it was developed through consultation with the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission, as well as with international financial regulators and a variety of market participants. In particular, the Treasury Department outlined numerous standards for covered bond programs to follow in order to be consistent with this *Best Practices* template, including that (1) issuers be either newly created bankruptcy-remote special purpose vehicles or depository institutions; (2) the maturity for covered bonds be greater than one year, and no more than 30 years; (3) issuers hold an overcollateralization value of at least 5% of the outstanding covered bond principal balance; (4) the covered bonds not account for greater than 4% of an issuer's liabilities after issuance; and (5) each covered bond issued have a specified investment contract.¹⁸

FDIC Financial Institution Letters

In the United States, the FDIC resolves financial problems of failing banks with insured deposits. To adapt covered bonds to the U.S. system, therefore, FDIC rules for resolving claims against insolvent banks that have outstanding covered bonds might have to be modified. The FDIC issued Financial Institution Letters (FIL) on covered bonds in 2008 (FIL 34-2008 and FIL 73-2008) that apply to insured depository institutions (IDI).¹⁹ The FDIC's final policy statement (73-2008) defined a covered bond as "a nondeposit, recourse debt obligation of an IDI with a term greater than one year and less than 30 years that is secured, directly or indirectly, by perfected security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages or, not exceeding 10 percent of the collateral for any covered bond issuance or

¹⁶ "Remarks by Secretary Henry M. Paulson Jr. on Recommendations from the President's Working Group on Financial Markets," Press Release, U.S. Department of Treasury, March 13, 2008, available at <http://www.treas.gov/press/releases/hp1102.htm>.

¹⁷ "Treasury Releases Best Practices to Encourage Additional Form of Mortgage Finance," Press Release, U.S. Department of Treasury, July 28, 2008, available at <http://www.treas.gov/press/releases/hp1102.htm>.

¹⁸ "Best Practices for Residential Covered Bonds", U.S. Department of Treasury, July 2008, available at <http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf>.

¹⁹ "FDIC Policy Statement on Covered Bonds," Federal Deposit Insurance Corporation, August 4, 2008, available at <http://www.fdic.gov/news/news/financial/2008/fil08073.html>.

series, AAA-rated mortgage-backed securities secured by eligible mortgages.”²⁰ This definition may have limited the scope of covered bonds by U.S. banks to mortgage assets. Eligible mortgages include those that conform to agency guidance, including guidances on subprime and nontraditional mortgages.

FIL 73-2008 addressed the FDIC’s intended policy should an insured depository fail. The FDIC noted that any liquidation of collateral of an IDI placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Consequently, issuers of covered bonds could incur additional costs from maintaining additional liquidity needed to insure continued payment on outstanding bonds if the FDIC as conservator or receiver were to fail to make payments or to provide access to the pledged collateral during these periods after any decision by the FDIC to terminate the covered bond transaction.

FDIC treatment of covered bonds was also an issue for financial market intervention after the Panic of 2008. On January 16, 2009, the FDIC announced that it would propose rule changes to its Temporary Liquidity Guarantee Program (TLGP) that extended the maturity of guarantee for some assets from three years to 10 years.²¹ Because covered bonds possess longer maturities, this announcement was perceived as a move by the FDIC to accommodate this type of senior unsecured bank debt under the TLGP.²² However, in May 2009, it was reported that FDIC Chairwoman Sheila Bair had decided to delay the implementation of this initiative.²³

Performance in Europe During the Financial Crisis

In contrast to the United States, the European Union (EU) covered bond market has been a traditional feature of Europe’s capital markets. As of the end of 2008, there was approximately 2.38 trillion euros in outstanding EU covered bonds.²⁴ There are various kinds of covered bonds in the EU market, but they can be categorized into two main types: regulated and structured. Regulated covered bonds are governed by specific legislation, including European directives, national legislation, and secondary legislation. Structured covered bonds operate outside any dedicated laws.²⁵ This distinction between regulated and structured European covered bonds is important because regulated covered bonds are subject to privileged financial market regulation, whereas their structured counterparts are not. Within the EU regulatory framework, two primary laws outlining the minimum requirements for a regulated covered bond are Article 22(4) of the

²⁰ “Covered Bond Policy Statement,” Federal Register, Vol. 73, No. 145, July 28, 2008.

²¹ “Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America,” press release, FDIC, January 16, 2009, available at <http://www.fdic.gov/news/news/press/2009/pr09004.html>.

²² Alison Vekshin, “FDIC Adding Covered Bonds to Liquidity Guarantee Program,” Bloomberg News, January 16, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=acuw6oiWXLvw&refer=home>.

²³ Rebecca Christie, “FDIC Won’t Extend Bank-Debt Guarantee Plan,” *Boston Globe*, May 16, 2009, available at http://www.boston.com/business/articles/2009/05/16/fdic_wont_extend_bank_debt_guarantee_plan.

²⁴ European Covered Bond Council, “ECBC Covered Bond Statistics for 2008,” available at <http://www.hypo.org/DocShareNoFrame/docs/2/KBMNBDGCAANJIAHPHIOKEAPODBG9DBYA1TE4Q/EMF/Docs/DLS/2009-00135.pdf>.

²⁵ For a comparative analysis of legal-based and structured bonds, see European Central Bank, “Covered Bonds in the EU Financial System,” December 2008, available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf.

1988 Directive on Undertakings for Collective Investments in Transferable Securities (UCITS), and the Capital Requirements Directive (CRD).²⁶

Because of global financial market instability, covered bonds have received significant attention from the European Central Bank (ECB). In particular, the ECB's Banking Supervision Committee (BSC) released a study in December 2008, *Covered Bonds in the EU Financial System*, which examined the impact of covered bonds on the stability of the EU financial system.²⁷ The BSC concluded in its report that EU covered bonds appeared relatively resilient to the recent global financial market turmoil, although covered bonds were adversely affected following the intensification of financial turbulence in September 2008. In an effort to assist European capital markets, the ECB in July 2009 began a one-year purchase program of approximately EUR 60 billion in covered bonds in both primary and secondary markets.²⁸

The overall covered bond market in Europe has fared better than the American private label-mortgage securitization market. For example, the average spread between the average covered bond yield and euro interest rate swap rate remained relatively stable (between 90 and 100 basis points) after the finalization of the December 2009 FSR to end-April 2010. The debt crisis in some European countries is having a negative effect, however, as evidenced by spreads of covered bonds widened considerably in some euro area countries after May 2010.²⁹ Furthermore, recently created funding facilities in Europe to deal with the sovereign debt crisis have given banks alternative sources to raise funds. The result was that European covered bond issuance was 40% lower in 2012 than in 2011 "as several banks took advantage of the ECB's three-year LTROs to fund future liabilities."³⁰

Legislation in Prior Congress: United States

Covered Bond Act of 2011 (H.R. 940, 112th Congress)

Representative Garrett introduced H.R. 940 on March 8, 2011. A related hearing was held on March 11, 2011, in the Subcommittee for Capital Markets and Government Sponsored Enterprises, of the House Committee on Financial Services. H.R. 940 would have established a statutory framework for covered bonds in the United States to replace the purely contractual system now in place. Under H.R. 940, the Department of Treasury would establish an oversight program for covered bonds. The federal banking regulators or the Treasury would have been the covered bond regulators (depending on the covered bond issuer), and the treatment of covered bonds in the case of bank failures would have been clarified. Key sections of H.R. 940 are presented below.

Eligible Assets Backing Covered Bonds (Section 2(7)). One question is whether covered bonds should be limited to residential mortgages, or whether other types of loans should be eligible assets for statutory designation (as opposed to a contractual covered bond). Under H.R. 940 as

²⁶ The legislative text of both Article 22(4) of UCITS and the CRD are available at <http://ecbc.hypo.org/content/default.asp?PageID=317>.

²⁷ "Covered Bonds in the EU Financial System," European Central Bank, December 2008, available at http://www.ecb.int/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf.

²⁸ European Central Bank, "Purchase Programme for Covered Bonds," press release, June 4, 2009, available at http://www.ecb.int/press/pr/date/2009/html/pr090604_1.en.html.

²⁹ European Central Bank, "Financial Stability Review, June 2010, p. 80, available at <http://www.ecb.int/pub/pdf/other/financialstabilityreview201006en.pdf?c66ac55577ca1ed83cd72b4d92aa17ec>.

³⁰ "Covered Bonds Face Another Tough Year," Ratings Direct, Standard & Poor's, January 24, 2013, p. 2, available at http://www.standardandpoors.com/spf/upload/Ratings_EMEA/24Jan2013_CoveredBondsFaceAnotherToughYear.pdf.

introduced, the covered bond statutory framework would be available for non-mortgage asset classes. H.R. 940 specifically included the potential to use covered bonds for certain residential mortgages, home equity loans, commercial mortgages, public sector securities, auto loans, student loans, credit card loans, and small business loans. Eligibility of asset classes would be dependent upon any rule or supervisory guidance from relevant federal agencies. In addition to these enumerated assets, the Secretary of Treasury would be allowed to designate additional types of eligible assets by rule, after consultation appropriate regulators.

Eligible Issuers of Covered Bonds (Section 2(9)). Under H.R. 940 as introduced, there would have been four categories of covered bond issuers. These included (1) insured depositories and their subsidiaries; (2) bank holding companies, savings and loan holding companies, and their subsidiaries; (3) nonbank financial companies and their subsidiaries that are approved by the covered bond regulator; and (4) any issuers that are sponsored by an eligible issuer for the sole purpose of issuing covered bonds on a pooled basis.

Federal Regulators of Covered Bond Programs (Section 2(6)). Although the Secretary of Treasury would have been directed to establish the covered bond regulatory oversight program, the federal banking regulators would have been the covered bond regulators for insured depositories and banks and savings and loan holding companies, and their affiliates, in general. The Secretary of Treasury would have been the covered bond regulator for entities without an existing federal banking regulator, such as some issuers that are sponsored by an eligible firm for the sole purpose of issuing covered bonds on a pooled basis.

Statutory Definition of a Covered Bond (Section 2(4)). Recall that contractual covered bonds are already legal in the United States. H.R. 940 would have created a statutory framework for covered bonds in the United States similar to programs in Europe that distinguish contractual from statutory covered bonds. H.R. 940 would have created a statutory definition for covered bonds. Under H.R. 940, the term *covered bond* would have meant any recourse debt obligation of an eligible issuer that (1) has an original term to maturity of not less than one year; (2) is secured by a perfected security interest in or other lien on a cover pool that is owned directly or indirectly by the issuer of the obligation; (3) is issued under a covered bond program that has been approved by the applicable covered bond regulator; (4) is identified in a register of covered bonds that is maintained by the Secretary; and (5) is not a deposit (as defined in section 3(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(1))).

Approval of Covered Bond Programs (Section 3). The Secretary of Treasury, in consultation with the federal banking regulators, would have had 180 days to issue rules to establish a covered bond oversight program. Eligible issuers would have had to get approval from their federal banking regulator (or other appropriate covered bond regulator if the eligible issuer is not a bank) for each covered bond program that they establish. Approval or denial was to be based upon standards issued by the Secretary of Treasury. Eligible issuers may have had more than one covered bond program. For example, eligible issuers may have one program for mortgages and another for student loans.

Registry of Covered Bond Programs (Section 3 (a)(3)). H.R. 940 would have created a national registry for covered bonds. The Treasury was to maintain a website with information on covered bond programs. The registry would have included information to identify covered bond issuers, their programs, the applicable regulator, holders of the covered bonds, independent asset monitors, and applicable indenture trustees.

Costs and Fees of Regulation (Section 3(a)(4)). The covered bond issuers would have been assessed fees to cover the costs of regulation. Each covered bond regulator would have established the fees to cover the aggregate costs of the covered bonds programs that they

supervised. The fees would not have been construed to be government funds or appropriated monies and shall not be subject to apportionment.

Overcollateralization (Section 3(b)). A covered bond is backed by the issuer and by specific assets. Overcollateralization refers to a requirement that the value of the assets in the cover pool backing the bond be greater than the expected liability of the bond. H.R. 940 would have established a number of standards for overcollateralization. These standards included rules to be issued by the Secretary of Treasury in consultation with the covered bond regulators and an asset-coverage test. Issuers of covered bonds would have been required to report information on overcollateralization to the Secretary of Treasury, covered bond regulator, holders of the covered bonds, the independent asset monitor, and the indenture trustee. The bill would have established minimum standards for eligible cover assets, such as a requirement that loans not be more than 60 days delinquent nor may the same loans be pledged as collateral for multiple cover pools. The bill also established notice and procedures should the assets in the cover pool subsequently fail to meet the asset-coverage test.

Treatment of Covered Bonds for Defaulting or Failing Issuers (Section 4). H.R. 940 would have established procedures should (1) an issuer of a covered bond default on the covered bonds prior to that issuer's failure and (2) the issuer of a covered bond go bankrupt or be placed under receivership or conservatorship. H.R. 940 would have created a separate estate for the asset pool backing the covered bond. A separate estate would have been established for each covered bond program established by the firm. The estate would have been liable for the applicable covered bonds when the estate is created. Each estate would not have been liable on any other obligation of the issuer. The holders of covered bonds would have retained their claims against the issuer if the assets in the separate estate do not fully cover the bond.

Transfer of Covered Bonds Under Receivership and Conservatorship (Section 4(c)). There may be instances in which an issuer of covered bonds is placed in receivership or conservatorship before the issuer defaults on any covered bond payments. If so, the FDIC would have been required to transfer the covered bond obligations and related asset-cover pools to another eligible covered bond issuer within 180 days.

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This report was originally written by Edward V. Murphy, former specialist in Financial Economics at CRS. Congressional clients with questions about this report's subject matter may contact Eric Weiss.

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